

# Washington University Journal of Law & Policy

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Volume 13 *Empirical Taxation*

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2003

## Introduction: Empirical Taxation

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### Recommended Citation

Nancy Staudt, *Introduction: Empirical Taxation*, 13 WASH. U. J. L. & POLY 1 (2003),  
[https://openscholarship.wustl.edu/law\\_journal\\_law\\_policy/vol13/iss1/2](https://openscholarship.wustl.edu/law_journal_law_policy/vol13/iss1/2)

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# Washington University Journal of Law & Policy

## Empirical Taxation

### Introduction

Nancy Staudt\*

Tax scholars have filled the legal literature with fascinating debates on theoretical and normative issues. These debates have led analysts to offer a wide range of reforms designed to advance their views on tax policy questions. Tax analysts, for example, have proposed mechanisms to deter the use of tax shelters,<sup>1</sup> promote public perceptions of tax fairness,<sup>2</sup> lead courts to interpret laws in a rational and consistent manner,<sup>3</sup> and curb partisan auditing procedures in the Internal Revenue Service.<sup>4</sup> In the abstract, these proposals nearly always seem sensible; indeed even *conflicting* proposals appear sound.<sup>5</sup> Unfortunately, however, the literature gives legislators little

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\* Professor of Law, Washington University School of Law. I thank Peter Weidenbeck for his thoughtful comments on this essay.

1. Peter Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and Tax Shelters*, 54 SMU L. REV. 41, 69-70 (2001) (exploring the market for tax shelters and proposing mechanisms to curb it).

2. Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2001) (investigating social norms and their role for improving tax compliance).

3. Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 871-87 (1991) (investigating trends in statutory interpretation and proposing that courts give substantial weight to tax legislative history that explains the legislation in question, but significantly less weight to legislative history that assumes an additional quasi-regulatory role).

4. Frederic G. Corneel, *The Service and the Private Practitioner: Face to Face and Hand in Hand—A Private Practitioner's View*, 11 AM. J. TAX POL'Y 343, 343-65 (1994) (identifying problematic IRS procedures and proposing improvements).

5. Compare Canellos, *supra* note 1 (proposing disclosure requirements and high penalties to discourage the use of the tax shelters), with David Wiesbach, *Business Purpose*,

guidance for selecting one proposal from another in the wide array of sound policy options.

This lack of guidance is associated with the fact that tax analysts often fail to assess the observable implications of their theories against empirical data. In short, while tax scholars freely opine on important issues of tax policy, few attempt to test whether their hypotheses hold true in the real world. Consider the following: over the course of the last decade, Lexis has electronically published roughly 2000 tax-related articles and essays.<sup>6</sup> Just 21% of this pool *mentioned* the word “empirical,”<sup>7</sup> and 1% were in fact empirical studies.<sup>8</sup> Yet, many, if not most, of the authors make empirical claims

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*Economic Substance, and Corporate Tax: The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73, 79-82 (2001) (advocating anti-shelter doctrines for discouraging tax avoidance).

6. A Lexis search of all articles written between 1993 and 2002 mentioning the terms “tax or taxation” in the title produced 1,972 articles. This search, of course, may be under-inclusive given that articles addressing taxation issues may not use the terms “tax” or “taxation” in the title. For example, Leandra Lederman has studied settlements in the context of tax court cases but this article was not included in my search. See Leandra Lederman, *Which Cases Go to Trial: An Empirical Study of Predictors of Failure to Settle*, 49 CASE W. RES. L. REV. 315 (1999).

7. Out of the 1,972 tax-related articles, 422 mention the term “empirical” either in the title or the text.

8. Using a very broad definition of “empirical,” a definition that includes virtually all articles in which the author collected data (but did not necessarily analyze via statistical tools), I identified 22 empirical studies in the extant tax literature published between 1993 and 2002, including: Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1993) (collecting data on tax responsiveness of venture capitalists and entrepreneurs in Silicon Valley start-ups); Daniel K. Benjamin & William R. Dougan, *Efficient Excise Taxation: The Evidence from Cigarettes*, 40 J.L. & ECON. 113 (1997) (study of cigarette taxes and the “ripple effect”); Dorothy A. Brown, *Race, Class, and Gender Essentialism in Tax Literature: The Joint Return*, 54 WASH. & LEE L. REV. 1469 (1997) (using census data to analyze marriage penalties); Paul L. Caron, *The Federal Tax Implications of Bush v. Gore*, 79 WASH. U. L.Q. 749 (2001) (systematic study of federal court cases citing Supreme Court opinion in *Commissioner v. Estate of Bosch*); Paul L. Caron, *The Federal Courts of Appeals’ Use of State Court Decision in Tax Cases: “Property Regard” Means “No Regard”*, 46 OKLA. L. REV. 443 (1993) (systematic study of federal appellate cases citing *Commissioner v. Estate of Bosch*); David N. Figlio & Arthur O’Sullivan, *The Local Response to Tax Limitation Measures: Do Local Governments Manipulate Voters to Increase Revenues?*, 44 J.L. & ECON. 233 (2001) (containing a study of cities subject to tax limits and the corresponding budget manipulations); Michael J. Graetz, *Paint-By-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609 (1995) (exploring the legislative costs associated with relying on distributional tables to make tax policy rather than more qualitative information); Richard A. Ippolito, *Reversion Taxes, Contingent Benefits, and the Decline in Pension Funding*, 44 J.L. & ECON. 199 (2001) (collecting and analyzing data on defined benefit plans and the minimum funding approach to private pensions); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing,*

about individual behavior and institutional decision making in an attempt to convince readers (and possibly legislators) of a particular view on tax policy.<sup>9</sup>

In this symposium we seek to move beyond theoretical and normative tax policy debates to study the real world effects of taxation. The contributors use a variety of empirical methods to shed new light on a range of complex tax issues. Although the articles in this collection will not settle long-standing debates—some studies raise more questions than they answer—we believe that empirical work is *necessary* for finding and implementing workable solutions to difficult tax problems. This does not mean we see no role for theorizing in taxation. Just the opposite is true. We hope to subject

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*and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993) (investigating intra-family resource allocation through survey data); Marc Linder, *Eisenhower-Era Marxist-Confiscatory Taxation: Requiem for the Rhetoric for the Rich*, 70 TUL. L. REV. 905 (1996) (collecting historical data on progressivity debates); Gil B. Manzon & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175 (2002) (collecting data on taxable income through publicly available financial statements); James Edward Maule, *Instant Replay, Weak Teams, and Disputed Calls: An Empirical Study of Alleged Tax Court Judge Bias*, 66 TENN. L. REV. 351 (1999); Jeffrey Milyo, *Electoral and Financial Effects of Changes in Committee Power: The Gramm-Rudman-Hollings Budget Reform, The Tax Reform Act of 1986 and the Money Committees in the House*, 40 J.L. & ECON. 93 (1997) (study of legislative committees and correlative powers); Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171 (1997) (study of congressional activity in state and local tax area); Beverly I. Moran & Daniel M. Schneider, *The Elephant and the Four Blind Men: The Burger Court and Its Federal Tax Decisions*, 39 HOW. L.J. 841 (1996) (engaging a systematic study of Supreme Court decision making in the Burger era); David M. Schizer, *Frictions as a Constraints on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) (analyzing tax costs associated with particular tax planning devices); David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339 (2000) (investigating effect of Treasury regulations on tax planning); Daniel M. Schneider, *Assessing and Predicting Who Wins Federal Tax Trial Decisions*, 37 WAKE FOREST L. REV. 473 (2002) (analyzing connections between federal tax outcomes and judges' social backgrounds); Daniel M. Schneider, *Empirical Research on Judicial Reasoning: Statutory Interpretation in Federal Tax Cases*, 31 N.M. L. REV. 325 (2001); Daniel M. Schneider, *Interpreting the Interpreters: Assessing Forty-Five Years of Tax Literature*, 4 FLA. TAX REV. 483 (1999) (investigating the tax literature for purposes of understanding trends in "tax culture"); David Schultz, *State Taxation of Interstate Commuters: Constitutional Doctrine in Search of Empirical Analysis*, 16 TOURO L. REV. 435 (2000); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993) (analyzing data on tax expenditure budget and campaign contributions)

9. The authors in this symposium are certainly subject to this criticism. See, e.g., Nancy C. Staudt, *Taxation Without Representation*, 55 N.Y.U. TAX L. REV. 554 (2002) (arguing that taxpayer status is a means by which individuals gain a voice in political debates).

the best theories to empirical investigation in order to understand better their real-world implications, and ultimately their viability for policy making.<sup>10</sup> Without theory, empiricism is merely a mechanism to describe the existing state of the world; informed by theory, we can use empirical methodologies to assess likely behavioral consequences of legal change can evaluate tax policy over the course of time.

The participants in this symposium are not the first tax scholars to recognize the importance of empirical work. Many scholars acknowledge that without data they cannot “prove” their thesis but can only offer “plausible assumptions” and cite to anecdotal evidence in making arguments about the tax laws.<sup>11</sup> In an attempt to move beyond “plausible assumptions” and into “definitive answers,” some tax scholars cite existing empirical studies (or the lack thereof) in an effort to bolster their arguments,<sup>12</sup> but few have undertaken original

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10. We agree with Marjorie E. Kornhauser’s argument that “the dismissal of theory and exaltation of empirical studies is unwarranted,” both are exceedingly important to good tax policy making. See Marjorie E. Kornhauser, *What Do Women Want: Feminism and the Progressive Income Tax*, 47 AM. U.L. REV. 151 (1997) (taking issue the vocal critics of “tax theory”).

11. See, e.g., Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1865 (1994) (“the proof of this point ultimately lies in empirical work yet to be done, and which I hope to help develop further in the future.”); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 383 (1995) (“Another problem that may have arisen as a consequence of *Burke* is that employment disputes that might have been settled may instead be channeled to the courts in the hope of having settlements characterized as excludable tort damages. The author has no empirical evidence that this has occurred, but accounts of such occurrences are circulating among some law firms.”); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1672 (1999) (“This section considers some additional examples of efficient line drawing to show that the approach is workable. The goal is to illustrate the recommended approach rather than to provide definitive answers to these problems. In particular, empirical research is necessary to determine the appropriate answers, and this section includes only what I hope are plausible assumptions.”); Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 507 (1998) (“My conclusions in this Part rest on theory and anecdotal evidence and thus are preliminary. Nevertheless, this study lays the foundation for further empirical analysis.”).

12. See, e.g., Anne L. Alstott, *Tax Policy and Feminism: Competing Goals and Institutional Choice*, 96 COLUM. L. REV. 2001 (1996) (drawing on a range of empirical studies found in the economic literature for purposes of understanding women’s labor force participation); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL’Y 221 (1995) (“a persuasive, utilitarian argument can be made that the benefits afforded individuals rise less than does their income, thus supporting regressivity, rather than progressivity. This author knows of

empirical research as a component of their scholarly agenda.

Of course, traditional legal scholars tend to lack training in social science methods and thus need to guard against selective empiricism in the service of a normative agenda. Some commentators are skeptical that legal policy analysts are capable of avoiding these pitfalls and of producing valid empirical research.<sup>13</sup> We agree with the skeptics that empirical research requires special skills and that without such skills we may publish flawed studies that confound, rather than clarify, difficult policy questions.<sup>14</sup> We also believe that empirical research is a key to good tax policy making, and that acquiring the skills necessary to collect and analyze data in a scientifically rigorous way is essential to equip traditional tax scholars with the proper means to find solutions to long-standing problems of tax policy.

Consider Professors William M. Gentry and David M. Schizer's article entitled, *Frictions and Tax-Motivated Hedging: An Empirical Exploration of Publicly-Traded Exchangeable Securities*. In this paper, the authors investigate a tax avoidance strategy known as "tax-free hedging," transactions that offer the benefits of a sale without triggering a realization event. Using publicly available data, the authors provide empirical evidence to support their claim that frictions (non-tax costs) discourage the use of publicly traded securities in these hedging transactions, and thus tax policy makers intent on protecting the tax base would do well to focus on private over-the-counter transactions. Without the empirical data collected and analyzed by these authors, legislators and policy makers may adopt strategies intended to deter tax avoidance that do not address the hedging activities that are the real threat uncovered by Professors Gentry and Schizer.<sup>15</sup>

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no persuasive empirical proof to the contrary").

13. Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 833 (2000) ("Empirical analysis is generally helpful. . . . Nevertheless, there are a number of reasons to be skeptical. . . . the capacity of legal policy analysts to do empirical research is limited. . . . [and] it would seem to be a mistake to allocate significant effort toward a refined question where the prospects of success appear to be dim.").

14. For an in-depth discussion of the problems facing lawyers who undertake empirical work, see Lee Epstein & Gary King, *The Rules of Inference*, 69 U. CHI. L. REV. 1 (2002).

15. For example, disclosure requirements and increased penalties may be more successful

Confronting issues of fairness, two articles in the collection suggest that tax avoidance may have more to do with an individual's perception about reciprocity than conventional economic analysis would predict. Professors Christopher C. Fennell and Lee Anne Fennel, in their article *Fear and Greed in Tax Policy: A Qualitative Research Agenda*, argue that taxpayers seem to have an aversion to paying taxes, an aversion that may be greater than that experienced with other types of losses, when they believe that other citizens are free riding on their contributions. Put differently, when taxpayers perceive a lack of reciprocity they are more likely to view the system as unfair and refuse to pay taxes on those grounds. If further empirical research (which the authors plan to undertake) supports this hypothesis, then Congress could ameliorate tax avoidance at the individual level with mechanisms that produce transparency and promote wide-spread taxpayer cooperation.

Professor John T. Scholz, a political scientist who has long studied tax compliance issues, also finds that taxpayers' perceptions of fairness impact their willingness to pay. In *Contractual Compliance and the Federal Income Tax System*, Professor Scholz first presents a theoretical framework for understanding why people pay taxes, and then argues that the American tax system has, in fact, developed in a manner that is consistent with his theory of "contractual compliance." Professor Scholz then notes that empirical studies (including his own) support his model of compliance, and at the same time suggest a variety of reforms that could further cooperation without excessive government coercion. Professor Scholz concludes by noting that these alternative approaches would not interfere with democratic values associated with individual rights.

Finally, four articles explore judicial decision making in the context of taxation. In *Exploring the "Myth of Parity" in State Taxation: State Court Decisions Interpreting Public Law 86-272*, Professor Bradley W. Joondeph notes that state and local tax lawyers routinely claim that the Tax Injunction Act (an Act that bars federal courts from hearing state and local tax lawsuits) produces biased and unfair outcomes. Their arguments rest on the hypothesis that state

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than broad anti-shelter doctrine for deterring tax-free hedging transactions. See Cannellos, *supra* note 1; Weisbach, *supra* note 5.

court judges are reluctant to strike down a state tax, even when it is in violation of federal law, because of the possible incentive to direct revenue into their own state coffers. To test this theory, Professor Joondeph collects every state court decision concerning Public Law 86-272, a federal statute that provides businesses with immunity from state income taxes when they keep their activities beneath a specific threshold. If state courts allowed immunity under the federal law then the argument that the state judges are biased would not hold. While his empirical findings are preliminary, Professor Joondeph believes his data do not support the assertion that state courts systematically disfavor taxpayers claiming protection under federal law.

Professors Robert M. Howard and David C. Nixon, two political scientists, investigate the role that federal courts have in directing IRS audit policies. Using cross sectional time series data from 1960 through 1988, the authors show that the IRS shifts its audits between business and individuals in response to the prevailing median ideology of the federal courts of appeals. Their essay, *Local Control of the Bureaucracy: Federal Appeals Courts, Ideology, and the Internal Revenue Service*, asserts that as the median federal court of appeals judge becomes more liberal, the IRS shifts its audit policy in that region to focus on business entities, and as the median appeals court judge becomes more conservative, the IRS increases individual audits. Professors Howard and Nixon's work has a strong and *unexpected* implication for scholars interested in IRS auditing policies and procedures, namely that effective reform must take into consideration the ideology of the federal judiciary, not simply the preferences of bureaucratic decision makers.

In *Statutory Construction in Federal Appellate Tax Cases: The Effect of Judge's Social Backgrounds and of Other Aspects of Litigation*, Professor Daniel M. Schneider explores the impact of social backgrounds on federal appellate court judging. In particular, Professor Schneider considers whether characteristics such as gender, race, or education affect judges' methods chosen for interpreting the tax code. Although normative debates on the importance of social background and judging abound, Professor Schnieder's work suggests that a judge's social background characteristics may not have a strong correlation with the *method* a judge uses to decide a case. His findings therefore may have important implications for



contemporary debates on diversity and federal judicial appointments.

Finally, Professors Lee Epstein, Peter Wiedenbeck and I explore judging in the Supreme Court context. In our essay, *Judging Statutes: Thoughts on Statutory Interpretation and Notes for a Project on the Internal Revenue Code*, we seek to understand what leads Supreme Court Justices to particular outcomes in taxation cases. The conventional wisdom among political scientists is that outcomes are the product of the Justices' efforts to advance their political ideologies, either by voting in accordance with their own sincerely held preferences, or via strategic decisionmaking that takes into account the behavior of other relevant actors (to avoid congressional override, for example). The empirical literature on the Supreme Court's interpretation of statutes, however, is largely based upon civil rights cases. We question whether the same results obtain in more economically oriented lawsuits, such as taxation. Indeed one of our preliminary findings suggests that Supreme Court decisions in tax controversies may be tied as much to the level of the national deficit as to individual ideology or concerns about congressional responses to particular decisions. Although our essay raises more questions than it answers, it explains the objectives and methodology of a comprehensive empirical study of Supreme Court tax decisions that is now underway.